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SUBJECT: MERKEL, STEINBRUECK STAND UP FOR BALANCED BUDGET

11. Summary: On September 16, against a backdrop of the global financial crisis and increasing demands for domestic spending, Finance Minister Peer Steinbrueck (SPD) introduced an FY 2009 budget of 288.4 billion Euros -- the Grand Coalition's third and last joint budget prior to the national elections in September 2009. In his Bundestag presentation, Steinbrueck touted the government's horn for having lowered the country's deficit to the lowest level since German unification. The tax windfall from the economy's robust performance during the last several years enables the government to increase the budget for defense, development assistance, education and infrastructure. However, parliamentarians across the political spectrum question the feasibility of Steinbrueck's goal of a balanced budget by 2011, particularly in light of increasing economic uncertainty and the growing demands for increased domestic spending as the parties gear up for the elections. End Summary.

Reaping the Benefits of Consolidation and Economic Growth

12. With the cost-saving measures of previous years now paying off, Steinbrueck announced that the FY 09 budget would include a deficit of only 10.5 billion euros, a third of what it had been in 2005. The deficit will be the lowest since German re-unification in 1990. Steinbrueck plans to cut the deficit even further (to 6 billion euros) in the 2010 budget and plans a balanced budget the following year. (Note: The deficit is with the Federal Budget; the state and communal entities already reported a budget surplus last year and will do so again this year). With 42.5 billion euros, Germany's debt service still makes up the second biggest line item in the budget.

13. Germany's FY-09 budget of 288.4 billion euros marks an increase of just 1.5%, one of the smallest in recent years. Germany's solid economic growth of more than 2% in 2007 and the significantly improved financial condition of Germany's various social welfare funds provided Steinbrueck even made some additional spending possible. The defense budget will receive 1.9 billion euros more compared to 2008, the Ministry for Development Assistance will see an increase of 800 million euros, and the budget for research and development will increase by 1.25 billion.

Uncertainties from the Financial Crisis

14. The budget debate took place under the growing gloom of international financial crisis and concerns over its possible spill-over into the German economy. In her September 17 budget speech to the Bundestag, Chancellor Merkel renewed her call for tighter regulatory control of the international financial system. She said rating

agencies that assess companies' financial health should be subject to a code of conduct. She did not repeat her earlier proposal for a European rating agency. Merkel also attempted to calm the public, saying that the effect on the German economy from the current crisis had been "moderate." (Note: Since then Merkel has used several campaign-related events to publicly call upon the U.S. and Britain to confront their serious shortcomings in financial regulation and has continued to stress tougher regulations and transparency in international finance markets as well as unspecified oversight of ratings agencies.)

15. Finance Minister Steinbrueck was more direct. While defending the underlying assumptions of his budget (especially the growth rate of 1.7% for 2008 and 1.2% for 2009), he warned that Germany would not escape the financial crisis completely, but also warned against the creation of a stimulus package, saying this "would only be money burned." (NOTE: Over the weekend of September 20-21, he downgraded the estimate for 2009 to 0.5%, and the prediction of 1.7% looks increasingly dubious.) Steinbrueck argued that Germany can best shield itself from international turmoil by staying on its budget consolidation course. FDP budget expert Otto Fricke told Steinbrueck that he should have reduced the budget deficit even further during the last two years, when strong growth generated a revenue windfall of more than 9 billion euros. All opposition speakers and some from the ruling parties expressed their doubts about the government's ability to reach a balanced budget by 2011. This view is shared by several of Germany's leading economic research institutes. The cooling of the economy will make it difficult for the

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government to retain the revenue level projected in the budget, Thomas Straubhaar of the Hamburg based HBWI said.

Growing Election Time Appetite

16. The beginning of a national election campaign has already wetted appetites for additional spending. The Bavarian CSU - facing state elections on September 28 - was the first party to demand additional tax reductions "to allow citizens to participate in Germany's improved economic situation." The grand coalition has also announced that it will further reduce individual contribution shares to the unemployment insurance fund from the current 3.3% to 3.0% - or even lower. The government is expected to approve a tax deduction increase for those paying child support. Foreign Minister and Vice Chancellor Steinmeier - the SPD's announced candidate for Chancellor in 2009 - has called for more spending on education. Finally, the commuter tax break is expected to be reinstated (due to a probable court decision), which will result in several billion euros worth of revenue losses for the federal budget.

Comment

17. Increasing pressures on spending during an election year coupled with the expected economic slowdown will make it difficult to stay the course. So far Steinbrueck's strong position within the SPD and the backing he receives from Chancellor Merkel have prevented any deviation from the government's budget consolidation course. Both are determined -- probably even more so in times of financial uncertainties -- to make budget consolidation one of the shining accomplishments of the CDU-SPD Coalition. For the German voter, such fiscal conservatism remains a virtue, particularly in times of crisis.

Koenig